THE CHANGING USES OF FINANCIAL STATEMENTS

BY

CHARLES LAWRENCE

B.S., University of Denver, 1943
M.S., University of Colorado, 1948

AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ACCOUNTANCY
IN THE GRADUATE COLLEGE OF THE
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The study of the changing uses of financial statements is the study of the heart of accounting's development, for the service of accounting lies primarily in the usefulness of its major product — financial statements. Certainly usefulness and interest in financial statements go hand in hand for they are inevitably related. Thus changes in the uses of financial statements are but reflections of changing interests in the reporting unit itself. The ability of the accounting mechanism — including reports — to adjust to new interests cannot be overemphasized. Even as economic conditions and legal forms of business enterprise have not long remained the same, so also accounting discipline and reports have not remained unchanged, but have served an ever widening circle of users.

However, satisfaction of many new interests does not automatically lead to harmonious inter-user relations, for each separate user seeks to have his own informational desires fully satisfied from the published statements. Though it is reasonable that financial statements should be published with a view to the widest service within the limits of currently accepted accounting doctrine, yet it is also necessary to weigh carefully the newer, wider demands for informational satisfaction. Wider interests in, and ever increasing demands for, financial statements must eventually push acccounting doctrine beyond the limit set by the present reporting system. Yet there may be limits beyond which accounting statements cannot validly be forced and still truly serve their original purposes.

As many newer uses of financial statements did not appear until after the formative period of enterprise reporting had passed, the question of their complete satisfaction is one which must be regarded as highly significant to the future progress of accounting. These newer uses developed slowly, but required ever more service from accounting reports. Historically, the origins of enterprise records were largely identified with the proprietor, probably first in that ageless business unit,

the single proprietorship. However, the single proprietorship form of enterprise was soon destined to sustain a substantial change by reason of the normal expansion of the extent and importance of organized trade and commerce. Successive forms of commercial activity, such as the general partnership, widened the "proprietary" service of the records of the enterprise.

But limited partnerships, joint stock companies, and the modern large corporation each successively caused a gradual metamorphis to take place in the character of enterprise proprietorship, so that eventually the "owner" took the place of the "proprietor." The major difference between the proprietor and the owner was that revealed in the ever less-direct relationship found between the owner and the enterprise. Though the directness of ownership displayed in modern single proprietorship is perhaps still as strong as that of old, the evidences of ownership under the corporate system do not show any such strong bonds of proprietary spirit with the enterprise — bonds which would enable the owners to directly identify themselves or their interests with the records of the enterprise. The concept of the identity of the owner-enterprise has vanished, and in its place management — an intermediate class between enterprise and owners — has come into being. Representative management-owner reporting has been substituted in the place of proprietary control — a substitution which requires by law, by concept of stewardship, and by economic necessity the reporting of the results of enterpirse operations to the owner, but which nonetheless is the inevitable successor to the direct enterprise-proprietor relationship so integral to the true proprietary spirit in an enterprise.

Inherent in the demise of the direct owner-participation in the affairs of the enterprise was the rise of the managerial use of financial statements. This managerial class is largely a product of the modern large scale corporate enterprise since large scale commerical organizations generally assumed the corporate form of organization. This form of organization first presented to absentee owners a task of management which

was impossible for the owners themselves to fulfill. The most reasonable answer to such a problem was the hiring of a professional class of managers to do the task that was impossible for the owners themselves to perform.

Management has become a function inseparable from accounting records and reports. Its very mission is the profitable operation of a given company. However, the separate identification of corporate management undoubtedly aggravated the frictions inherent in communication between enterprise and owner. Absentee ownership, typical of current commercial organizations, makes enterprise communication with owners a major problem, and has caused financial statements to be considered as the only substantial financial link between the company and the owners. Communicative representation in this area has now become a major problem of management.

Management, which has full control of all the information generated by the corporate activity, must intelligently summarize it previous to publication in order that it be useable and understandable. Management also formulates the basic records and summarizes pertinent information therefrom in the manner most suitable to carrying out its primary function — the control and operation of the business unit. That this information — formulated, summarized, and published from the basic enterprise records — does not completely satisfy the owners, is somewhat less than serious, for it seems reasonable to conclude that management, by its appointed task, now appears to be the foremost interest in the company, and, as separately constituted, the primary user of enterprise information. Owners, by comparison, make but little use of the total information of the company. In general this use is limited (a) to judging the financial productivity of their committed investment, and (b) to judging the success of the management in controlling the enterprise by virtue of the productivity of the investment. Thus the new use of financial information by the "owner" (as differentiated from the "proprietor") seems to be of much lesser strength than that of his enterprise representative, the "management". However,

owner-proprietor-manager uses are harmonious and wholly consistent with the spirit of the traditional accounting doctrines.

A concomitant development of large scale corporate enterprise is the resort to credit financing. Prior to the use of financial statements by creditors, only the proprietary interests (including their representative, management) had access to the information in enterprise financial statements. With the development of large scale indutsry and with the increasing popularity of the corporate form of enterprise, more capital was needed. Credit transactions, earlier considered to be exceptional, soon became the rule in large scale business, and the proprietor's traditional personal guarantee of repayment was replaced by the financial representations of enterprise's financial condition. Thus financial statements became an integral part of the credit transaction in the twentieth century largely because of the change in form and scope of the business endeavor. However, in this use of financial statements also, the basic premise still held that the publication of financial information was limited to only those with direct financial interests in the enterprise. It is significant to note that the creditor use of financial information was one of the last uses that was in complete harmony with the original proprietary spirit of financial information.

The uses heretofore mentioned form a rather homogeneous group with regard to the treatment of enterprise financial information. The major characteristics in common are the focus upon the individual unit, the common bond of direct financial risk, and mutually agreed upon concepts and goals of corporate progress. At this point, also, the bookkeeping system has been fairly well developed, and the reports of enterprise information were made to those risking funds in the enterprise. It is significant to call attention to the harmony of these early views in order to assess more clearly the differences in the character of later uses, for these have tended to change the goals and rearrange the concepts upon which accounting and accounting reports have been developed in their conquest

for better service from reports of business enterprises.

Perhaps the least divergent of the newer uses is that of the investor. The growth of the small investor has been one of the most important financial phenomena of the twentieth century. Because of the rise of the corporate form of organization, coupled with the existence of a strong stock market investment system, the small investor-owner comprises an ever increasing segment of the investing public. The most disturbing aspect of the emergence of the small investor class in modern America is the resultant deterioration of personal contact of the investor with the enterprise, and, as a result, the importance that has been placed upon the financial statements as the major communication link between the company and the investor.

The investor, however, is primarily interested in the future expectations of his investment. His uses of financial statements are concerned with comparing the given company's prospects with those of alternative investments in regard to (a) future earnings and dividend policies, (b) probable risk compared to expected income, and (c) the probable market increase in value. Investors are thus interested in comparing many financial statements and information of many alternative investments. It is of course important for the investor's own welfare, as well as that of society in general, that his investment decisions be based upon the most accurate, pertinent, current data of which he is able to avail himself. Yet there are limitations on the amount of information that can be derived from present financial statements. Some of the limitations are (1) financial statement information is limited by the infrequency of its publication, and as a result some noncurrency attaches to such information when it reaches the investor's hands in a report, (2) the limited scope of direct financial statement coverege (being addressed to stockholders only) of all investor classes, and (3) the seemingly small segment of the investing public that can comprehend the terminology used in, and arrangement of, financial statements. However, more basic than these physical limitations of

financial statement usefulness is the fundamentally irreconcilable difference in interest between the investor and the corporation. The investor focuses his interest upon his own initial cost, and works from this cost-aggregate as a basis; the company focuses its attention upon the representation of the enterprise as a whole, as a single, going-unit; the investor is vitally affected by stock market changes, the corporation but little; finally, the investor considers the given company's financial information as but a part of the necessary knowledge to alert investment (as he must be concerned about many other alternative investment opportunities); the enterprise, on the other hand, is wholly comprehended in the results presented by the reports of the given enterprise. It is, perhaps, above all other differences, this investor necessity for comparative financial data that most separates this use of financial statements from its traditional predecessors.

Another modern use, arising in the twentieth century is that by organized labor. The growth in mere numbers of union members is tremendous, but that growth has not caused as much concern as labor's new business concepts: for instance, labor's new concept that its wages are not to be considered primarily as costs, but are to be considered and paid for in terms of social contribution; i.e., paid as earned rewards to the major factor of production. Labor dismisses, herewith, the traditional cost-profit concept of payment and submits instead their prerogative to be treated in payment decisions in a manner reflecting labor's newly obtained economic strength. Another example of this change in attitude is labor's new concept of management: that management should be socially alerted to the opportunity of benefitting labor — an opportunity which, in the eyes of many, has been neglected for many years. In general, labor's rise represents a capitalization of a social feeling which has come into all parts of the current culture in the past half century.

Specifically, labor wants the full financial information of the company disclosed in financial statements. This desire stems from labor's proposed use of this enterprise information

(1) to determine the "ability to pay" (labor) of the enterprise (judged upon and by labor's new concepts), (2) to compute a simple productivity index — eventually to be used to point out the proper reward of labor in a given profit situation, and (3) to disclose all internal accounting facts fully so that decisions therein regarding profits, prices and wages may be critically reviewed by labor representatives.

It seems in reality that labor interests are not as concerned about having the financial statements reflect the full facts about the business decisions made as in actually "aiding" in the managerial judgement exercised in guiding an enterprise. Labor makes use of financial statements not primarily as a report of enterprise activity, but as a record of managerial judgement served up for correction. Labor's goal, likewise, is not the increase in profitable return to the enterprise, but of the leveling off of enterprise residual return and the siphoning off of all "surplus" earnings to labor. Finally, in labor's use, the profit information presented by enterprise statements is not to be judged by factors related to costs and selling prices therein, but upon the relationship of the residual profit figure to social income, social cost, and social benefits to a particular class. Because these fundamental changes in the viewpoint of labor are contrary to traditional business concepts upon which the financial statements are constituted, it is to be surmised that labor is expecting more service from financial statements than it is possible for them to give. Thus, this new use of financial statement information (founded upon the present basis of reporting and accounting) cannot objectively be fully validated.

Another modernly constituted use of financial statement information is that by government. Though there are infinite variations in the relationship of business and government in society, the trend in modern America is towards the growth of government limitations on business. Such limitations and controls have hinged to an ever increasing extent upon information furnished by the accounting records of individual business enterprises. Though nineteenth century government

— business relations were characterized by laissez faire with minor governmental interest in business operations, government policy subsequently shifted towards one showing more interest in business operations. Early evidence of this shift is found in the Interstate Commerce Commission's activities, which consist largely of regulating agencies of public transportation FOR the public interest. Later, after the 1929-1932 depression, a more definitely restrictive philosophy of business limitation was adopted as a working policy by the government. This policy may be termed regulation BY the public (government) interest, and is typified by the Tennessee Valley Authority as a "yardstick". The suspension of the cost-profits test in the yardstick operations, combined with the general government treatment of business data by aggregates and by uniform wholes, gives evidence that this use of financial data of business units is not harmonious with earlier traditional uses. Under these circumstances, the financial peculiarities of the individual enterprise must be submerged in the group picture; the results must be determined profitable or unprofitable by socially conceived concepts, not by the usual business standards. This is another modern use of financial statement data that holds new financial concepts and that substitutes different goals for those held fundamental in connection with the basic reporting unit — the individual enterprise.

The last example of a modern use of financial statements — that of the economist — is the most divergent from the earlier uses. Though early economic reasoning had evolved a theory of the unit and the individual market — a viewpoint reconcilable to accounting viewpoints — the new school of national income economics which arose during the time of the 1929-1932 depression came to use financial information in a manner quite different from its predecessors. The new use of accounting was directed towards society as a whole and towards societal goals. But this new view towards society did not share the focus placed upon the transactions of the individual unit nor the concept of profit involved in these enterprise reports. Thus necessarily accounting data, as

normally presented, was poorly adapted to this new use.

This new use of accounting data possessed no direct financial interest in the enterprise. Rather, economists' demands for informational satisfaction rested almost solely upon their claim that they must have data for the "national welfare." The aggregative approach of this economic view to business data (since herein all business data are considered uniform and part of a homogeneous whole) raises a basic question as to the wisdom of attempting this use of accounting data.

The apparent presumption seems to be that the multitudinous transactions and the complex inter-reactions of the whole economy can be objectively pictured and simply charted in five "accounts" into which semi-accounting data are entered as in statistical categories. It is to be called "semi-accounting" data because the raw business data from accounts are considerably reworked (by additions, deletions, and exclusions) before reappearing in the form of the measurements of national activity, such as national income. As a result, considerable difference is to be found between treatment in accounting reports and economic treatment of identical business data. Again, "income" connotes to accountants the result of a matching process (realized profit with incurred cost) with a possibility that either profit or loss may be the result. National "income", built up in part from the same basic business figures, has no such connotation of opposites, but is to a large extent merely a summary of payments to various factors of production. Again, this "national income" recognizes only such increments as contribute some "social" gain, whereas the basic business reports do not hold out any such qualification to their figures for income. Transaction measurement, so important to enterprise accounting, is suspended by this user and imputations of all sorts — interest, leasehold returns, etc, — are added to the reported business figures. Other items reported in business financial reports are freely excluded from economic summaries of business operations. Surely accounting reports derive much of their inherent validity from the

fact they present the full story of *all* the happenings related to a given enterprise during a given period. A use of accounting data which requires additions and subtractions resulting in material changes in the information originally reported must be closely examined as to its validity.

All these new interests, widely varied though they be, demand that additional information be included in, or that new relationships be set forth by, the financial statements of business enterprises. Each demand adds to the already great demands of present users for financial statement data. However, the most important fact is not that of the numerical increase in users, but in the fact that the newer demands for information form a group of users that is materially different from traditional users. This group successively leads towards a philosophy of reporting entirely different from that originally involved in enterprise reports.

The historically conceived view of financial reporting emphasizes the individual company's transactions, and holds the primary focus of reporting to be on the given company in all situations: it is the view which has fostered the highly significant cost-profit relationship. This relationship originated in the early proprietor's use of enterprise reports, and it continues to be invaluable in the managerial use of these same reports to guide the enterprise. Under this philosophy of reporting, the full disclosure of the financial peculiarities of a particular company are considered to be of the utmost importance, for it is the full report of all that happens to the individual enterprise that makes these reports serviceable.

The newer uses of accounting statements require a changed philosophy of reporting which does not carry forward these early characteristics, and does not subscribe to the earlier viewpoint. The reporting focus of these newer interests is not on the fortunes of the individual unit and its emphasis is not upon the individual enterprise. These newer uses tend to submerge the importance of the individual enterprise's reports and conceal the full showing of the unit's financial peculiarities

in a haste to obtain comparability and near uniformity in group reports. From the apparent comparability wished for by investors to the consolidated uniformity demanded in national income aggregates, this tendency has steadily grown. The newer uses also sweep aside the direct financial interest in an enterprise as a prerogative to receiving information from it. Instead it is assumed that a primary duty of enterprise management is to report completely to all asserted interests on an equal basis as sort of a social responsibility. Thus under such an "enlightened" reporting system, the casual user's demand for financial information is to be considered equal in importance to that of the person who risked funds in the enterprise. Finally, under the more modern concepts of the uses of financial statements, an overall aggregate unit of some sort not only overshadows the importance of individual enterprises as units, but may wholly take its place and becomes THE unit of reporting. The enterprise report thus becomes only a small part of the desired total information, and has importance only because of its partial contribution to the aggregation of some greater whole. It is the combination of these above mentioned divergencies comprehended in the newer uses of accounting that causes so much questioning in accounting circles. The problem basically summarizes in this fashion: Can an enterprise-focused technique be refocused upon society and not lose its original use? Will not the modifications of basic concepts necessary to the implementation of the new reporting techniques ultimately facilitate the submergence of the calculation of business profits to a civil or a politically appointed authority?

The solution of the problem is not easily found. In the first place, little progress can be made until many more people are made aware of the basic differences in focus and in profit concepts inherent in the newer uses of accounting statements. Once this distinction is rather widely perceived, then the question of the "proper" focus of accounting reports can be more readily considered. The question of which philosophy shall prevail, and of who shall determine the "proper" course

of reporting's development, will then have to be made a part of that consideration.

Some bare beginnings to possible solutions may be suggested here. First of all the test of reasonableness of data and method must surely not be ignored. One application of this test is to push to the limit the two alternative philosophies of reporting — enterprise — society. Pushed to one extreme the individual enterprise reports serve only the direct financial interests themselves; they would thus again serve only owners as in former times. This would undoubtedly be a regression of accounting's progress in a social and in a historical sense, but its effect on the accounting discipline itself would be negligible. Pushed to the other extrme — complete social integration, uniformly and rigidly construed — enterprise reports with a societal profit concept as a guide would tend to destroy enterprise managerial initiative, and to bind and confine the free spirit of individual enterprise, starting from the reporting function and working back to the original decisions and actions. If reasonableness then is to be a test, the social uses must be very carefully weighed before drastic accounting-service commitments are made which involve reconstructions of basic accounting theory.

This dissertation has not solved the problem of choosing which reporting philosophy is to be preferred, nor has it been intended that this mission should here be attempted. The two currents of development have been carefully charted; they seem to be diametrically opposed to one another. The major uses of financial statement data, as currently summarized and reported, have been analyzed by uses, and their separately constituted interests in the present type of financial information carefully considered. The decision to prefer to follow or to reject the traditional basis must be made on an individual basis by each business man, accounting student, accounting practitioner, or teacher. The decision should be based on full knowledge of the effects that this decision probably will have on the mechanism itself. The uses of accounting information are changing; how far these changes may be allowed to affect

traditional accounting should be worked out only on the basis of thoughtful consideration and full discussion of the comparative uses and interests involved. Accounting as practiced, and financial statements under the present reporting system, have played an ever increasing part in the development of skillful and alert enterprise management. It may be concluded therefore that new methods should not be adopted and these old methods should not be abandoned in favor of new concepts which would materially foreshorten the beneficial effects of rational accounting measurement of enterprise effort. Abandoment of basic principles seems involved more and more in these newer uses of accounting statements; this result is not in harmony with either the historical or the current spirit of financial reporting under enterprise accrual accounting.

VITA

Charles Lawrence was born on August 29, 1921, in Denver, Colorado. After graduating from North Denver High School in 1939, he entered the University of Denver, and received the degree of Bachelor of Science from that institution in June, 1943. He was employed by Ralph B. Mayo and Co., Certified Public Accountants, from June, 1942, until called to the U. S. Naval Construction Battalions in 1943. Upon discharge from the Navy in 1945, he completed his experience requirement for the C. P. A. degree, and was awarded a C. P. A. certificate by the State of Colorado in August, 1946. He then entered the graduate college of the University of Colorado and began teaching accounting subjects. He was awarded a Master of Science degree in 1948. In 1949 he entered the graduate college of the University of Illinois. He started teaching on the staff at the University of Illinois in 1950.